(26)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 785

MAURICE LEVY,

Petitioner,

v.

GUY T. HELVERING, Commissioner of Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

ANDREW B. TRUDGIAN,
Counsel for Petitioner.

THE COURT PRESS, N. Y. C.

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IN THE

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OCTOBER TERM, 1942.

No. .

MAURICE LEVY,

Petitioner,

v.

GUY T. HELVERING, Commissioner of Internal Revenue,

Respondent.

Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Petitioner respectfully prays that a writ of certiorari issue to review a judgment of the Circuit Court of Appeals for the Second Circuit entered in the above cause on December 16, 1942.

Opinions Below.

The opinion of the Tax Court of the United States (R. 12-17) is reported in 46 B. T. A. 423. The opinion of the United States Court of Appeals for the Second Circuit (R. 27) has not been reported.

Jurisdiction.

The judgment of the United States Circuit Court of Appeals was entered December 16, 1942. The

jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

For the calendar year 1937, the respondent disallowed a partial bad debt deduction in the amount of $13,283.84, contending that it was a capital loss and subject to the $2,000 capital loss limitation, because the debt was sold in the same year it was charged off for the amount to which it was written down and levied a deficiency assessment in the amount of $2,782.12. The Circuit Court of Appeals of the Second Circuit has affirmed the respondent's disallowance of the partial bad debt deduction because of the sale despite the fact that it conceded that the debt had become partially bad during the taxable year and had been properly charged off. The questions presented are:

I—Whether an account receivable can be a capital asset?

II—Whether a charge-off on a partial bad debt deduction can be made at any time during the taxable year?

III—Whether a deduction for a partial bad debt otherwise proper can be disallowed because of a subsequent sale of the underlying account within the taxable year?

Statement.

The facts as found by the Tax Court of the United States (R. 12-15) and by the Circuit Court of Appeals of the Second Circuit (R. 27) are as follows:

The petitioner is an individual engaged in the business of importing and manufacturing perfumery and toilet articles in New York City. In 1926 he organized Maurice Levy Co., Ltd., a Canadian company, to conduct a similar business in Montreal, Canada. At the time of the organization of the Canadian corporation, petitioner advanced cash to it and sold it merchandise and continued so to do thereafter. The amount representing the advance and sales was carried on petitioner's books as an account receivable. During the period 1926 to 1937 the only credits to this account were for payments made in 1931, 1933 and 1934 and for the return of merchandise in 1935. On December 31, 1936 the corporation had a deficit of $19,871.26 and as of April 22, 1937, the balance of the account due from the corporation to the petitioner was $27,837.84. Prior to September 1936, the corporation had manufactured for another corporation, Charles of the Ritz of Canada; this source of income being the corporation's only profitable one. In September 1936, the arrangement was changed so that Charles of the Ritz of Canada did its own manufacturing and the corporation shared to the extent of 50% of the net profits of Charles of the Ritz of Canada.

In March 1937, the petitioner determined that this new arrangement was unprofitable and that the likelihood of his ever collecting the entire amount due to him from the corporation was dubious. On April 27,

1937, W. N. Beauchamp, the manager of the Canadian corporation, offered to purchase petitioner's stock in the corporation for the sum of $2,200 and at the same time arrangements were made for the petitioner to sell his account due from the corporation to Beauchamp for the sum of $14,544 and the sale of this account was completed on June 19, 1937. Petitioner received the cash both from the sale of the stock and from the sale of the debt of the corporation and deposited both items in his personal bank account causing the amount received to be credited to his personal account on his books. On December 31, 1937, petitioner charged off the corporation's account and his investment in its stock by the following entry:

"Profit and Loss	$14,583.84	
Maurice Levy personal	16,754.00	
Maurice Levy, Ltd.		$27,837.84
Investment		3,500.00

To write off uncollectible investment and receivables."

On his income tax return for the calendar year 1937, petitioner claimed a deduction for a bad debt in the amount of $13,283.84, the difference between the amount of the debt $27,837.84 and its selling price $14,554.00. He also claimed a loss on the sale of the stock in the amount of $1,300, the difference between $3,500 and $2,200.

The respondent disallowed the $13,283.84 as a bad debt deduction on the ground that the loss sustained in that amount was a capital loss limited to $2,000 under the provisions of Section 117 of the Revenue Act of 1936. On appeal the Tax Court of the United States sustained the Commissioner's disallowance (R.

18) and on further appeal to the Circuit Court of Appeals, this order was affirmed (R. 31).

Specification of Errors to be Urged.

The Circuit Court of Appeals erred:

1. In holding that an account receivable arising in the course of business is a capital asset within the meaning of Section 117 of the Revenue Act of 1936.

2. In holding that the charge-off of a partial bad debt must be made at the same time as its ascertainment of partial worthlessness.

3. In holding that a sale of a debt subsequent to the ascertainment of its partial worthlessness and prior to its charge-off results in the negating of its otherwise proper use as a partial bad debt deduction.

4. In holding that a deduction for a partial bad debt is governed by the loss provisions of the tax statutes.

5. In failing to hold that the conceded proper ascertainment of partial worthlessness and proper charge-off during the taxable year did not create a partial bad debt deduction.

6. In failing to hold that the subsequent sale of an account receivable previously ascertained to be partially worthless, had no effect upon its deduction as a partial bad debt.

7. In affirming the decision of the Tax Court of the United States.

Reasons for Granting the Writ.

The decision of the Circuit Court of Appeals, Second Circuit, in the instant case is in direct conflict with the principles enunciated by this Court in the cases of *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243, and *Spring City Foundry Co.* v. *Comm.*, 292 U. S. 182, to the effect that the provisions in the tax statutes allowing deductions for losses and for bad debts are mutually exclusive and that losses on debts are not to be regarded as falling under the general provision for loss deductions. It is also in conflict with the decision of the Circuit Court of Appeals, First Circuit, in the case of *Hamlen* v. *Welch*, 116 F. (2d) 413, and with the decisions of the Circuit Court of Appeals, Seventh Circuit, in the cases of *Commissioner* v. *MacDonald Engineering Co.*, 102 F. (2d) 942, and *Rubinkam* v. *Commissioner*, 118 F. (2d) 148.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

ANDREW B. TRUDGIAN,
Counsel for Petitioner.

BRIEF IN SUPPORT OF THE PETITION.

Argument.

POINT I.

An account receivable arising in the ordinary course of business is not a capital asset within the meaning of Section 117 of the Revenue Act of 1936.

Section 117 (b) of the Revenue of 1936 defines capital assets as follows:

> "For the purposes of this title, 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of the kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"

and the Treasury Regulations promulgated under that Act further define the term "capital assets" as follows:

> "The term 'capital assets' includes all classes of property not specifically excluded by Section 117 (b) * * *" (Art. 117-1).

Superficially it would appear that accounts receivable would be capital assets under this definition of the statute and the regulations and the Circuit Court

of Appeals in the instant case so assumes. However, isolated words or phrases cannot be picked out of their context to determine the meanings of statutes, or for that matter constitutional amendments, but the entire statute or constitutional amendment must be interpreted as a whole and in respect to the underlying fault which was intended to be corrected. Thus the apparently unrestricted taxing power granted to the Federal Government by the Sixteenth Amendment to the Constitution was interpreted in the case of *Brushaber* v. *Union Pacific Railroad Company,* 240 U. S. 1, merely as the exclusion of the source from which a taxed income was derived as the criterion in determining its constitutionality, thus merely overcoming the previous constitutional inhibition contained in the case of *Pollock* v. *Farmers Loan & Trust Co.,* 157 U. S. 429, but not otherwise extending the Federal tax power. Likewise, in the instant case the definition of capital assets and a limitation on capital losses must be considered in connection with the evil sought to be eliminated.

The limitation on capital losses was first contained in the Revenue Act of 1934 the purpose being to safeguard the loss of revenues caused by deducting capital losses, which were mostly paper losses, from net income. This is well illustrated by discussion of this provision of the Act on the floor of the House where Representative Samuel B. Hill, for the House Ways and Means Committee, explained the situation as follows:

> "The Committee feels it has absolutely plugged that avenue from which taxes were escaping by manipulation of capital investments purely for the purpose of creating paper losses in order that

> they might offset those losses against ordinary income and thereby reduce the taxes of the taxpaper" (Congressional Record, Vol. 78, p. 2663).

The important thing to notice here is that Congress was dealing with investments and not with ordinary debts arising in the course of business.

The very nature of an account receivable makes these sections of the tax law inapplicable to them. Since there is no fluctuation in its market value, which is unrelated to its real value, any depreciation in value is immediately a real loss in contra-distinction to an investment which may fluctuate in its market value without any relationship to its real value. This section of the law is intended to apply to that type of property which fluctuates in its market value without any relationship to its real value, thus enabling a taxpayer to take a loss which is purely a paper loss, being able to repurchase his investment at a later period. On the other hand, an account receivable is a distinctive asset which cannot be speculated in and whose decline in value is caused only by a real loss of value which is presently deductible by a taxpayer under the bad debt provisions of the law.

Because of these clear and obvious distinctions between investments and accounts receivable and because the evil sought to be corrected by Section 117 (b) and (d) of the 1936 Act arose only in connection with investments, an account receivable is not a capital asset within the meaning of Section 117 despite its broad definition.

POINT II.

Capital loss provisions of the Revenue Act of 1936 do not apply to bad debts.

Assuming for the sake of argument that an account receivable is a capital asset within the meaning of Section 117 of the Revenue Act of 1936, nevertheless, the capital loss limitations of that Act do not apply to a bad debt. This Court has held that the deductions for bad debts and for losses are mutually exclusive and that a deduction under one is not affected by the provisions of the other. *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243; *Spring City Foundry Company* v. *Commissioner*, 292 U. S. 182. In the latter case, the Court explains the reason for its ruling as follows:

> "The making of the specific provision as to debts indicates that these were to be considered as a special class and that losses on debts were not to be regarded as falling under the preceding general provision."

Thus, this Court has construed the bad debt deduction to be a special loss deduction carved out from the general loss deduction and to be governed independently by its own rules *sui generis* and not to be limited by any provision of the loss deduction.

While these cases are concerned only with the distinction between the loss deduction and bad debt deduction, the principles enunciated therein are equally applicable to the capital loss provisions since these were intended as further limitations on losses and were not intended as limitations on bad debt deductions. The position of these provisions of the law

in the 1936 Revenue Act further confirms this point. In Section 23, the general deduction section, losses of individuals are governed by subdivision E, and of corporations by subdivision F. Sub-sections G, H, I and J are limitations on the general loss provisions respectively governing wagering losses, the basis for determining loss, wash sale losses and capital losses. After these loss sub-sections are completed, there comes sub-section K which deals with bad debt deductions and is clearly not modified by any provisions of the preceding loss deduction sub-sections.

Since the opinion of the Court below agrees that the debt in question became partially worthless in 1937, and also that the charge-off requirements of Section 23 (k) of the 1936 Revenue Act were complied with, the petitioner's claimed bad debt deduction must be allowed without any regard to the capital loss provisions of the tax law.

POINT III.

A charge-off on the books of a partial bad debt need not be made simultaneously with the ascertainment of partial worthlessness but can be made at any time within the taxable year.

The lower Court in the instant case has ruled against the taxpayer on the theory that although he had properly ascertained his account receivable to be partially worthless prior to his sale of it, the sale before his charge-off of the partial bad debt on his books left nothing to be charged off, so that there was not proper compliance with the bad debt provisions of the tax statute. The Court thus erroneously assumes that the charge-off for a partial bad

debt must be made simultaneously with the ascertainment of partial worthlessness and cannot be made during the taxable year. The law on the subject does not so provide, merely limiting the portion of a bad debt deductible as a partial bad debt to that part charged off within the taxable year. This is not a limitation by way of time but by way of amount and there is no indication that the treatment of partial bad debts, as far as the charge-off requirement is concerned, is any different from that of the treatment of totally worthless debts.

On the subject of totally worthless debts, the First and Seventh Circuit Courts of Appeals are in agreement that a charge-off at any time within a taxable year or even after the end of the taxable year, if made as of the end of the taxable year, is sufficient. *Hamlen* v. *Welch*, 116 Fed. (2d) 413, First Circuit; *Commissioner* v. *MacDonald Engineering Co.*, 102 Fed. (2d) 942, Seventh Circuit; *Rubinkam* v. *Commissioner*, 118 Fed. (2d) 148, Seventh Circuit.

In *Hamlen* v. *Welch*, *supra*, the Court explains the charge-off as follows:

> "It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence as to the ascertainment of worthlessness substantially as of the date of such ascertainment and confirmation thereof."

In the *Rubinkam* case, *supra*, the charge-off was actually made in February of the year following the taxable year in which the loss was claimed and this was held to comply with the statutory requirements. Thus, in the First and Seventh Circuits, as well as

in innumerable Tax Court cases, the charge-off requirement for bad debt deductions is regarded as merely confirmative of the ascertainment of worthlessness and can be made at any time within the taxable year or as of the end of the taxable year. Since the petitioner herein has met this test and the opinion of the lower court so concedes ("it is also clear that the taxpayer literally complied with the language of the statute in that he actually made the charge-off within the taxable period for which he claimed the deduction"), the partial bad debt loss was effective prior to the sale of the underlying account receivable and its sale should have no effect on the tax consequences of the partial bad debt loss but is merely confirmatory of the value of that partial bad debt loss.

Conclusion.

In view of the conflict of the decision of the Court below with various decisions of this Court and the other Circuits, and because of the widespread effect of the principles involved, to wit, the proper delineation of the bad debt, loss and capital loss-deductions, this petition for a writ of certiorari should be granted.

Respectfully submitted,

ANDREW B. TRUDGIAN,
Counsel for Petitioner.

Appendix.

Revenue Act of 1936, c. 690, 49 Stat. 1648.

Section 23—Deductions from Gross Income:

In computing net income there shall be allowed as deductions:

(k) Bad debts.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

Section 117.

(b) Definition of capital assets.—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(d) Limitation on capital losses.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges.

Treas. Reg. 94 (1936 Ed.).

Art. 23 (k)-1.

Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible.

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In the Supreme Court of the United States

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MAURICE LEVY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the United States Board of Tax Appeals (R. 12–17) are reported in 46 B. T. A. 423. The opinion of the Circuit Court of Appeals (R. 27–30) is reported in 131 F. 2d 544.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 16, 1942 (R. 31). The

petition for a writ of certiorari was filed March 4, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

On June 19, 1937, the taxpayer sold an account receivable for $13,283.84 less than its face value, and on December 31, 1937, charged off the account as a bad debt. The question is whether the $13,283.84 is deductible in full as a partial bad debt under Section 23 (k) of the Revenue Act of 1936, or represents a capital loss which may be deducted only to the extent of $2,000 under Section 117.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations are set forth in the Appendix, *infra,* pp. 7–8.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 12–15) may be stated as follows:

The taxpayer is an individual engaged in the importing and manufacturing of perfumery and toilet articles in New York City. In 1926 he organized Maurice Levy Company, Ltd., a Canadian corporation, to conduct a similar business in Montreal, Canada. From time to time the taxpayer advanced cash to the corporation and sold it merchandise on credit, the amounts repre-

senting the advances and sales being carried on the taxpayer's books as an account receivable. From 1926 to 1937 payments were made by the corporation on the account and during that period the corporation paid off all its creditors except the taxpayer. As of April 22, 1937, the corporation owed the taxpayer $27,837.84. (R. 12–13.)

Prior to September 1936, the corporation had manufactured for another concern, known as Charles of the Ritz of Canada, and this source of income was the corporation's only profitable one. In September 1936, this arrangement was changed so that Charles did its own manufacturing and the corporation took half of the net profits of Charles. In March 1937, the taxpayer found that the new arrangement was unprofitable. (R. 13.)

On April 27, 1937, W. N. Beauchamp, the manager of the corporation, offered to purchase the taxpayer's stock in the corporation for $2,200, and this offer was thereupon accepted. At the same time the taxpayer offered to sell Beauchamp the debt owed the taxpayer by the corporation for $14,554. The offer was accepted by Beauchamp on June 19, 1937. The transaction was closed on that basis and the taxpayer deposited cash received to his account and credited the same to his personal account on his books. (R. 13–14.)

On December 31, 1937, the taxpayer charged

off the corporation's account and his investment in the stock by the following entry (R. 14):

Profit and loss	$14,583.84	
Maurice Levy personal	16,754.00	
Maurice Levy, Ltd.		$27,837.84
Investment		3,500.00

To write off uncollectible investment and receivables.

On his income tax return for the year 1937, the taxpayer claimed a capital loss of $1,300 on the sale of the corporation's stock, and claimed a deduction as a bad debt in the amount of $13,283.84. The latter is the difference between $27,837.84, the face amount of the amount of the account receivable, and $14,554, the sum actually received for it. The Commissioner of Internal Revenue disallowed the deduction of $13,283.84 as a bad debt, holding that the transaction constituted the sale of a capital asset within the meaning of Section 117 of the Revenue Act of 1936, and the loss was limited to $2,000. (R. 14–15.)

The Board of Tax Appeals sustained the action of the Commissioner (R. 17) and on appeal the Circuit Court of Appeals affirmed (R. 30).

ARGUMENT

There is no conflict and the decision below is correct. The precise question is whether a debt may be charged off for the purpose of a deduction under Section 23 (k) of the Revenue Act of 1936 (Appendix, *infra,* p. 7), after the obligation has been sold. The Board of Tax Appeals and the Circuit Court of Appeals correctly held that Section 23 (k) is inapplicable and that the transac-

tion resulted in a loss from the sale of a capital asset which is deductible only to the extent permitted by Section 117 (d), *infra.*

1. The Circuit Court of Appeals dealt with the case on the theory that the debt was "admittedly" a capital asset (R. 27). This conclusion followed from the petitioner's concession in the Board of Tax Appeals (R. 16) and his failure to contend otherwise in the court below. In any event, no conflict is predicated upon the point and petitioner presents no authority whatever in support of the contention now made that an account receivable is not a capital asset. Nor is there any conflict, as alleged (Pet. 6), with the cases holding that the loss and bad debt provisions are mutually exclusive, for, as recognized by the court below (R. 29–30), they have no application where there is a closed transaction such as the sale herein which brings the loss provisions into play.

2. Since Section 23 (k) allows a deduction for debts "charged off", it is implicit that the statute is concerned with assets which still appear on the books. This construction was adopted in *Reed* v. *Commissioner,* 129 F. 2d 908, 912 (C. C. A. 4th), and petitioner presents no authority to the contrary. Here the property had been sold and there remained no debt which could thereafter affect petitioner's tax liability.

3. The court below did not place its decision upon the ground that the charge-off of a partial bad debt must be made simultaneously with the

ascertainment of partial worthlessness. Accordingly, petitioner's authorities to the contrary are inapplicable.

CONCLUSION

There is no conflict of decisions and no reason requiring a review by this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

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SEWALL KEY,
J. LOUIS MONARCH,
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Special Assistants to the Attorney General.

MARCH 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Definition of capital assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *

* * * * *

Treasury Regulations 94, promulgated under the the Revenue Act of 1936:

ART. 23 (k)–1. *Bad debts.*—Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or

* * * * *

If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. * * * Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible.

* * * * *

ART. 117–1. *Meaning of capital assets.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). In determining whether property is a "capital asset," the period for which held is immaterial.

* * * * *

ART. 117–4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)–3), or loss sustained as the result of corporate stock or debts becoming worthless.

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